NO. 80-1203

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

THE STATE OF NEW JERSEY,

Petitioner,

v.

READING COMPANY, Debtor in Reorganization, THE UNITED STATES OF AMERICA, CONSOLIDATED RAIL CORPORATION and the COMMITTEE OF INTERLINE RAILROADS,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

I

In setting forth its statement of the facts, Reading Company asserts that the State of New Jersey, with a claim of about $250,000, was the only one of some 12,000 credi-

tors, claimants and stockholders to object to and challenge the approval of the plan of reorganization on appeal. Reading also states that subsequent to the reorganization court's approval of the plan, the plan was submitted to the creditors and stockholders for a vote and was "overwhelmingly" accepted and thereafter confirmed by the court. Confirmation led to an order to implement the plan and what is termed the "successful" consummation of the reorganization plan.

Reading's misleading and incomplete summarization of the case is employed here in an effort to convince the Court that this matter lacks the requisite importance to justify grant of the Writ of Certiorari. It is true that after the plan was approved by the reorganization court, it was submitted to the claimants and stockholders for a vote on its approval. What Reading fails to note is that the State of New Jersey challenged the Trustees' contention that the holders of more than two-thirds of the claims in Class C and Class D, the classes in which the State's claims are classified, had voted to accept the plan. Further, the State urged that the absence of the requisite voting majorities mandated denial of the Trustees' petition for confirmation and that the reorganization court was without power to confirm or cram down the plan over the objecting votes of administration claimants entitled to cash payment of their claims pursuant to Section 77(e)(3) of the Bankruptcy Act. These objections, overruled by the district court, are now the basis of an appeal from the confirmation order pending in the Third Circuit. *In the Matter of Reading Company,* (3rd Cir., No. 80-2670).

It is to be emphasized that neither the voting results nor the comparative size of the State's claim have any relevance to the merits of the substantial and important issues raised in this case. As this Court stated in *Case* v. *Los Angeles Products Lumber Co.,* 308 U.S. 106 (1939);

> ". . . all those interested in the estate are entitled to the court's protection. Accordingly the fact that the vast majority of the security holders have approved the plan is not the test of whether the plan is a fair and equitable one. . . .
>
> Hence, in this case the fact that 92.81% in the amount of the bonds, 99.75% of the Class A stock, and 90% of the Class B stock have approved the plan is as *immaterial on the basic issue of its fairness as is the fact that petitioners own only $18,500 face amount of a large bond issue.*" *Id.*, 308 U.S. at 114-115. (emphasis added).

The same principles set forth in *Case* v. *Los Angeles Products Lumber Co., supra,* would apply to Reading's suggestion that consummation of the plan diminishes the importance of the issues raised by the State. Reading fails to mention that the State has not received any payment pursuant to the plan because of a continuing dispute over the amount of the State's claims.* Further, at the hearing on the proposed consummation decree, the Trustees stipulated that sufficient cash had been reserved to pay the State of New Jersey in full and in cash if that were ordered. In the order, entered on December 24, 1980, the reorganization court reserved jurisdiction to direct the distribution of whatever amounts of cash or securities as may be necessary should the State succeed on appeal. The fact that other claimants and creditors have accepted the

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* Over the State's objections, the plan was approved despite its failure to recognize interest upon tax claims according to the statutory rates. The reorganization court refused to resolve the issue at the approval stage (App. A, 33a). The reorganization court later refused to order any payment of *undisputed* amounts as part of its consummation decree.

reorganization plan, and the fact that other claimants and creditors have received payment under the plan is wholly irrelevant and does not in any way diminish the importance of the statutory and constitutional questions raised in this case.

II

In urging this Court to deny the State of New Jersey's petition for certiorari, Reading Company maintains that there are no special and important reasons which would justify review by this Court. This contention, joined by the United States, is premised upon the assertion that the reorganization court's decision approving the plan of reorganization was consistent with the applicable decisions of this Court and did not involve any question of federal law which had not already been settled by this Court. Notwithstanding Reading's assertion to the contrary, the approval of the Reading plan by the district court was wholly at odds with the prior decisions of this Court and also raised substantial questions of law not heretofore settled by this Court.

Reading's argument starts and stops with the notion that a compromise of claims in a reorganization is a normal part of the reorganization process. Reading fails to state the obvious. Any compromise forming part of a reorganization plan must be "fair and equitable" within the meaning of Section 77(e)(1) of the Bankruptcy Act. See *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc.* v. *Anderson*, 390 U.S. 414, 424 (1968). Moreover, no plan can be deemed "fair and equitable" if it "*compromises* the rights of senior creditors in order to protect junior creditors." *United States* v.

Key, 397 U.S. 322, 327 (1970) (emphasis added).* As amply argued in the State's petition, the treatment of its high priority tax claims under the approved plan is violative of the "fair and equitable" requirement and the absolute priority rule. No decision of this Court can be read to justify a plan of reorganization which provides for the payment of fully secured administration property tax claims with only 30% in cash at consummation and the balance in the form of long term securities of uncertain payment, which provides for the payment of fully secured administration franchise tax claims entirely in the form of long term securities of uncertain payment, and yet accords *unsecured* creditors payment of 33⅓% in cash at consummation and guaranteed payment of the balance within two years of consummation. The wholesale departure from this Court's decisions concerning the "fair and equitable" requirement approved by the district court, and sanctioned by the Third Circuit, is indisputably a matter of the utmost importance under the bankruptcy laws.

The fact that the provisions of Section 77 of the Bankruptcy Act have been superceded by the enactment of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 11 U.S.C. §101 *et seq.*, does not lessen the importance

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* In its reply memorandum, the United States notes that it *voluntarily* agreed to compromise its claims including claims which were accorded a first priority under Section 211(h) of the Rail Act, 45 U.S.C. §721(h). That that United States chose to accept deferred payment from the proceeds of the Reading Valuation Case, a proceeding in which the United States is the defendant, does not require that the other high priority claimants similarly agree to deferred payment or justify an imposed "compromise" which mandates deferred payment. This is particularly true where, as here, the "compromise" of the State's tax claims is employed as a means to protect junior creditors and accord to them preferential payment in a manner contrary to the scheme of priorities.

of the issues raised as to the fairness and equity of the Reading reorganization plan. Railroad reorganization proceedings commenced under Section 77 will continue to be governed by the provisions of Section 77. See Pub. L. 95-598, §403(a) and (b). In addition, the "fair and equitable" requirement of Section 77(e)(1) has been carried forward in the Bankruptcy Reform Act of 1978. The "fair and equitable" requirement applies to corporate reorganization plans generally, 11 U.S.C. §1129(b), and to railroad reorganization plans in particular. See 11 U.S.C. §1173(a)(1). It can well be expected that cases dealing with the application of the "fair and equitable" requirement under the former Bankruptcy Act will be looked to in weighing the validity of reorganization plans under the new law. Clearly, the provisions of the Bankruptcy Reform Act of 1978 only serve to highlight the importance of the issues raised in this matter.

The question of whether Section 77(e)(3) of the Bankruptcy Act requires that the State of New Jersey's long deferred administration tax claims be paid in cash is similarly a question of no small importance. In *In the Matter of the Central Railrod Co. of New Jersey,* 579 F.2d 804, 809 (3rd Cir. 1978), the Court of Appeals expressly stated that the issue was one "with wide ranging implications." Despite Reading assertions, this is a question which has not been resolved by this Court, which has importance beyond the parameters of this case, and which should be decided by this Court.

III

Both Reading Company and the United States cavalierly dismiss the State's Tenth Amendment arguments and also urge the denial of the petition on that basis. Both respondents fail to recognize the basic fact that the State of New Jersey's claims in this proceeding arose by the most egregious intrusion upon State sovereignty, the entry of a tax payment deferral order which suspended the taxing power of the State.* The respondents, like the Court's below, ignore the fundamental principle reaffirmed in *National League of Cities* v. *Usery,* 426 U.S. 833, 850 (1976),

> ". . . that a State is not merely a factor in the 'shifting economic arrangements' of the private sector of the economy, *Kovacs* v. *Cooper,* 336 U.S. 77 (1949) (Frankfurter, J., concurring), but is itself a coordinate element in the system established by the Framers for governing our Federal union."

Thus, when a federal power is exercised, even an expressly delegated power, the exercise of that power as against a sovereign state is strictly limited by the Tenth

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* This serves to distinguish the claims asserted in this matter from those pre-reorganization tax claims at issue in *Gardner* v. *New Jersey,* 329 U.S. 565 (1947). The State was compelled to become a claimant by judicial fiat. As Judge Fullam stated with respect to the deferral of tax payments in *In re Penn Central Transportation Co.,* 382 F.Supp. 856, 869 (E.D. Pa. 1974):

> ". . . the immediate impact of continued loss operations is being absorbed by state and local taxing authorities . . . whatever may be said of trade creditors and investors, *surely the local taxing authorities . . . cannot be said to have made an investment decision of any kind or to have extended credit voluntarily to the railroad.*" (emphasis added).

Amendment. Accordingly, there is no merit to the Reading argument that a determination that the Reading plan comports with Section 77 resolves the Tenth Amendment issues. An analysis of the Tenth Amendment issues begins rather than ends with consideration of the exercise of federal power.

In support of their view that the approved plan's treatment of the State's tax claims does not violate the Tenth Amendment, both respondents rely upon *Fry* v. *United States,* 421 U.S. 542 (1975), and the discussion of *Fry* in this Court's opinion in *National League of Cities* v. *Usery, supra.* The United States likens the approval of the plan of reorganization to the Economic Stabilization Act in *Fry* v. *United States, supra,* which was determined to displace no State choices as to how governmental operations should be structured nor compel the States to remake such choices. See *National League of Cities* v. *Usery, supra,* 426 U.S. at 853. The distinctions drawn by the Court between the Economic Stabilization Act in *Fry* and the extension of the Fair Labor Standards Act in *Usery* totally undermine the analogy. As Justice Rehnquist stated of the wage freeze imposed under the Economic Stabilization Act:

> ". . . [it] displaced no state choices as to how governmental operations should be structured, nor did it force the states to remake such choices themselves. Instead, it merely required that the wage scales and employment relationships which the states themselves had chosen be maintained during the period of the emergency. Finally, the Economic Stabilization Act operated to reduce the pressures upon state budgets rather than increase them." *Id.,* 426 U.S. at 853.

In the matter *sub judice,* the reorganization court set aside the policy determinations that underlie the State's taxing statutes, statutes which were enacted to provide the State with revenues needed to provide essential services to the State's citizens. The reorganization court determined that the taxes imposed by the statutes would not be paid when the statutes said they were to be paid. Taxes initially deferred as early as 1972 are now, under the approved plan, to be further deferred and might never be paid. Clearly, this is not a preservation of the *status quo* as in *Fry* v. *United States, supra.* State choices as to what taxes are to be imposed, when they are to be paid, how the tax monies are to be employed, and what level of State services are to be maintained, have been summarily displaced and continue to be displaced by federal action in violation of the Tenth Amendment. The conflict between the decision of the reorganization court and this Court's decision in *National League of Cities* v. *Usery, supra,* is clear.

CONCLUSION

For these reasons, and those previously stated, the petitioner State of New Jersey respectfully submits that the petition for writ of certiorari should be granted.

Respectfully submitted,

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